TrendMacrolytics

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MACROCOSM

Better Than It Looks

Monday, October 30, 2006
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Third quarter reported growth was dragged down by isolated factors likely not to repeat -- the expansion is still very much intact.

We usually consider massive data aggregates such as GDP of limited usefulness to the task of shaping a forward-looking outlook, but the headline 1.6% real growth rate reported in Friday's advance GDP release was both a surprise and a disappointment. Heading into the release, our analysis was that the economy appeared to have advanced at an annual rate of at least 3% in the third quarter (see "What Landing?" October 20, 2006). We allowed for the possibility that the reported growth rate could come in below 3% due largely to the decline in "net exports" occasioned by a rising trade deficit, but we didn't anticipate the slippage to a sub-2% rate.

As it turns out, the greater than expected deceleration could actually contain the seeds for faster reported growth in coming quarters. That's because the housing downturn subtracted 1.1% from the growth rate, after taking about 0.7% off growth in the second quarter. It's not likely that the residential investment slump will continue to extract that kind of price from growth. Indeed, there already are signs that the housing market has seen the worst of it, even if only in rate-of-change terms. New home sales, for example, have risen for the past two months. If the worst of the correction has been absorbed, that will mean less of a subtraction from growth going forward, and thus higher reported growth rates.

Update to strategic view
US MACRO: The preliminary third quarter GDP report paints a falsely alarmist picture of slowing growth. Housing and net imports explain the whole drop, and those factors are not likely to repeat in the current quarter. We expect reported real growth at 3%-plus for the fourth quarter. **FED FUNDS:** The report of slow GDP growth in the third quarter will probably keep the Fed on pause at the December FOMC meeting. But we continue to believe that the next rate move will be higher, not lower -- though now it seems likely that the first hike won't come till the January meeting.
[see Investment Strategy Dashboard]

Similarly, a good part of the 0.6% hit to growth accounted for by the decline in net exports could well be reversed in the current quarter owing to the fact that oil prices have fallen into their current range around $60 per barrel only since the tail end of the third quarter. Prices were still above $70 through the first two months of the quarter. As long as crude prices don't spike higher again, the quarter-to-quarter decline in the oil import tab will show through as a significant improvement in net exports.

Apart from these two statistical drags on growth, the GDP release captures the underlying fundamentals of an economy maintaining a solid 3%-plus rate of expansion. While conventional wisdom has been awaiting the supposedly inevitable demise of "the consumer" owing to the housing downturn, personal consumption expenditures rose by 3.1%, an improvement on the 2.6% consumption growth of the second quarter. Even the always gloomy *New York Times* was moved to note this "remarkable" resilience in the face of the "pricking of the housing bubble."

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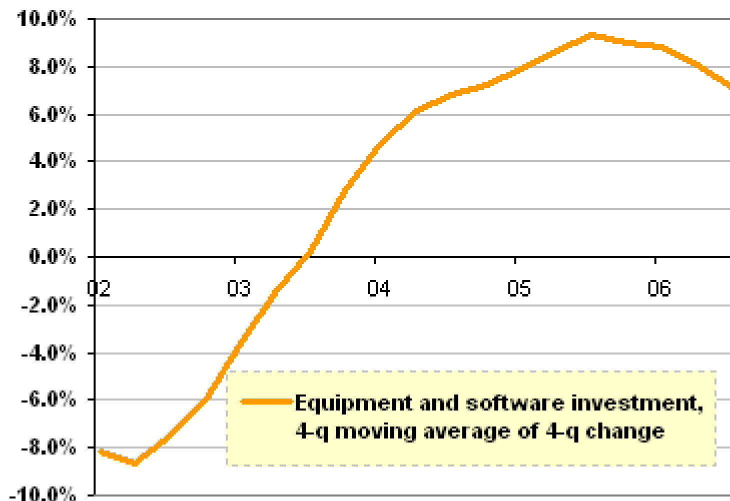
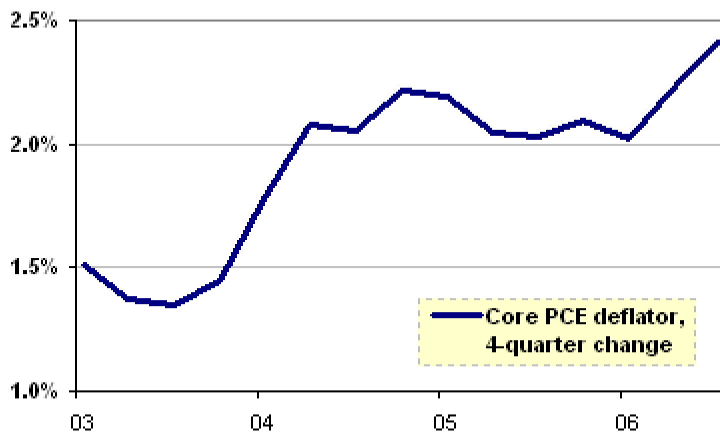
Nonresidential fixed investment, meanwhile, grew by 8.6% -- including a 6.4% gain for equipment and software spending. This is not the stuff of an economy heading into a slowdown, and given the unlikelihood that residential investment and net exports can contribute the same drag as they did in the last quarter, we expect growth to return to the 3% range in the current quarter.



NOT EXACTLY THE STUFF RECESSIONS ARE MADE OF!

Bonds rallied on the slower than expected growth report, with the 10-year Treasury moving back below 4.7% and the interest rate futures markets renewing their bet for a full 50 basis points in rate cuts next year, but we continue to see very little chance that the Fed's next move will be to cut rates. While the Fed's preferred inflation indicator, the core personal consumption deflator, dropped back from 2.7% to 2.3% in the quarter, on a 4-quarter basis it is now at an 11-year high of 2.4%. And with gold jumping back above $600 and the dollar trading lower on the GDP news, it's clear that the bigger risk remains that the Fed has done too little, not too much. For the moment, the Fed is no doubt comforted to get some news that seems to justify its premature pause at 5.25%. But a restoration of a 3% growth track this quarter likely will not go down easy at the central bank. The output gap obsessed Fed staff is already marking down its estimate of "growth potential," and restoration of a 3% pace can be expected to sound all the neo-Keynesian alarms about "resource utilization" and "capacity constraints."



NOT EXACTLY A REASON FOR THE FED TO CUT RATES!

BOTTOM LINE: An economy maintaining strength in consumption, investment and imports is not an economy on the cusp of a downturn. With signs of some stabilization in the housing market and the decline in oil prices, a considerable growth rebound in the current quarter seems most likely. Credit markets took the predictable path of rekindling their rate cut hopes on the slower than expected growth, but that is likely to be as much an out-of-the-money bet as ever. Friday's GDP report may well give the Fed the justification it needs to stay on pause through the December FOMC meeting. But with the Fed's favored price index at 11-year highs and growth likely to rebound to the 3% range, we maintain our call that the next move in the overnight target rate will be higher, and it could eventually go considerably higher. TM